Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:MCT:PHI:TL-N-1794-00
JRGilbert

date:

to: Francis J. Koneski, Case Manager, E:1542
(King of Prussia Post of Duty)

from: Associate Area Counsel (LM:MCT), Philadelphia

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subject: **Request for Counsel Assistance - [redacted] - Deductibility of Stock Option and Bonus Payments**

DISCLOSURE STATEMENT

This memorandum constitutes return information subject to section 6103 of the Internal Revenue Code[1]. It contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. This advice may not be disclosed to taxpayers or their representatives.

DISCUSSION

This memorandum is a partial response to an inquiry from Team Coordinator Don Cronauer, concerning certain deductions for stock option and bonus payments claimed by the subsidiary [redacted]. ("[redacted]") on [redacted]'s ("[redacted]") consolidated Form 1120 for fiscal year ending February 28, [redacted] ("FYE [redacted]"). This memorandum supersedes our memorandum dated [redacted].

ISSUES

1. Whether the payments made by [redacted] in [redacted], to acquire stock options and warrants from its employees and directors should be capitalized.

2. If the answer to question 1 is "no", whether the

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[1] Except as otherwise noted, all references are to the Internal Revenue Code of 1986, as amended.

payments for options and warrants are deductible on the [redacted] final return for its short period fiscal year ending December 12, [redacted] ("FYE [redacted]"), or on the consolidated [redacted] return for FYE [redacted].

3. Whether the bonus payments made by [redacted] on [redacted], to employees covered by the its Executive Incentive Plan should be capitalized.

4. If the answer to question 3 is "no", whether the bonus payments are deductible on the [redacted] final return for FYE [redacted], or on the consolidated [redacted] return for FYE [redacted].

CONCLUSIONS

1. No. The deductibility of the stock options is governed by § 83(h), which allows the deduction to the service recipient. Since [redacted] was the service recipient, and the amounts paid to cancel the options satisfied compensation obligations of [redacted] existing before the reorganization, they are deductible by [redacted] as a pre-existing obligation of a compensatory nature, and do not have to be capitalized as an expense of the reorganization.

2. We will provide a response to this question in a future advisory memorandum.

3. No. [redacted] is not required to capitalize the payment of the bonuses, because these payments also constituted the satisfaction by it of a pre-existing obligation of a compensatory nature. As a result, the bonuses are deductible under § 162.

4. The payments for bonuses are deductible on the [redacted] consolidated return for FYE [redacted]. While the services generating the bonuses were rendered prior to the merger on [redacted], they can not be deducted by [redacted] on its final short period return, because the bonuses were paid more than [redacted] months after the close of the tax year. Since [redacted] was part of the [redacted] consolidated group subsequent to the merger, the bonuses can be deducted on the FYE [redacted] consolidated return.

FACTS

Background

[redacted] corporation is one of the largest retail [redacted] chains in the United States. According to [redacted]'s annual report for the fiscal year ending February 28, [redacted], it was then operating over [redacted] in [redacted] eastern and western states and the District of Columbia.

[redacted] ("[redacted]"), the [redacted] retailer in the [redacted] United States, was a corporation whose stock was publicly traded before its being acquired by [redacted] on [redacted]. Prior to the merger, [redacted] was an accrual-basis taxpayer which filed its annual federal income tax returns using a fiscal year-end of [redacted]. [redacted]'s final Form 1120 covered the short period from [redacted].

Stock Option Plans

Prior to its merger into [redacted] on [redacted], [redacted] maintained two stock option plans for its employees and directors. The [redacted] Management Equity Plan provided for the sale to key [redacted] employees of shares of [redacted] common stock and for the grant to such key employees of options to purchase such shares, with a purchase price or exercise price, as the case may be, based upon the market price of such stock on the date of sale or grant. Grants of stock options under the plan were made pursuant to a Stock Option and Stockholders Agreement, which generally provided that the options vested in installments of [redacted]% per annum over a [redacted]-year period from the date of grant. Options granted under the plan were designated either as incentive stock options ("ISOs") within the meaning of § 422 or as options that do not so qualify. The options granted pursuant to this plan did not have a readily ascertainable fair market value at the time of grant.

The [redacted] provided for the grant of options to directors of [redacted]. The options granted pursuant to this plan did not have a readily ascertainable fair market value at the time of grant. Vesting of options under such plan accelerated upon a change of control of [redacted].

On [redacted], [redacted] and [redacted] executed a merger agreement[2] which contained the following provisions with respect to [redacted]'s stock option plans:

[2] The merger agreement was first executed on [redacted], and later amended on [redacted].

[redacted]

[redacted]

On [redacted], the [redacted]-[redacted] merger[3] was consummated. Pursuant to the merger agreement, [redacted] purchased incentive stock options and nonstatutory stock options previously granted to various of its employees and directors. All outstanding options and warrants for the purchase of [redacted]'s common stock, including those issued to officers and directors of [redacted], were vested and converted into the right to receive cash for the difference

[3] We note a technical discrepancy between the merger agreement (which states that [redacted] will merge into [redacted], with [redacted] as the surviving corporation in the merger) and the position taken by [redacted] with regard to the transaction on the FYE [redacted] Form 1120 (namely, that the transaction was a "B" reorganization, with [redacted] surviving as a consolidated subsidiary of [redacted]). Since the FYE [redacted] and subsequent returns indicate that [redacted] did in fact survive as a subsidiary, we assume for purposes of this advisory that [redacted] and [redacted] subsequently modified the merger agreement.

between the respective exercise price of the underlying option or warrant and [redacted] percent of the closing price of [redacted]'s common stock at [redacted].

At the effective time of the Merger, the [redacted] Plan and the [redacted] Plan were terminated. The conversion of outstanding options and warrants into cash ($[redacted]), were paid for by [redacted] through the use of funds provided by [redacted].[4] Each [redacted] employee or director who held options or warrants as of the merger date was required to execute a release (see attached as Exhibit "A"), which stated in pertinent part that "the undersigned has received from [redacted] the cash payment owed to the undersigned upon cancellation of his or her options and/or warrants in accordance with [the merger]". [redacted] reflected the taxable portion of the stock option income for all affected employees on their [redacted] Forms W-2, and on Forms 1099 for the non-employee directors.

On [redacted]'s consolidated tax return for the fiscal year ending [redacted], [redacted] deducted the amounts paid to its employees and directors to purchase their options ($[redacted]).

Cash Bonus Plan

For some time prior to the [redacted] merger, [redacted] had maintained an "Executive Incentive Plan" which called for the payment of cash bonuses to its executives based upon the corporation's attainment of specified profitability goals.

Provided that [redacted] achieved certain performance objectives for the period beginning [redacted][5] and ending on the effective date of the merger ([redacted]), [redacted] agreed to pay prorated bonuses to its executives [redacted] days after the close of FYE [redacted]. In accordance with this agreement, [redacted] paid approximately $[redacted] of bonuses to its executives on [redacted], and it deducted these bonuses on [redacted]'s consolidated tax return for the fiscal year ending February 28, [redacted]. [redacted] reported these bonuses for all affected employees on their [redacted] Forms W-2.

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[4] The [redacted] Form 8-K dated [redacted] filed with the U.S. Securities and Exchange Commission stated that "[redacted]."

[5] The beginning of [redacted]'s fiscal year.

LAW

Section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property (determined without regard to any restriction other than a restriction that by its terms will never lapse) at the first time the rights of the person having the beneficial interest in the property are transferable or not subject to a substantial risk of forfeiture, whichever occurs earlier, over the amount paid for the property is included in the gross income of the person who performed the services in the first taxable year in which the rights of the person having the beneficial interest are transferable or not subject to a substantial risk of forfeiture.

Treas. Reg. § 1.83-7(a) of the regulations establishes rules for options to which § 421 does not apply and that do not have a readily ascertainable fair market value at the time of grant. Under those rules, §§ 83(a) and 83(b) apply at the time such an option is exercised or otherwise disposed of, even though its fair market value may have become readily ascertainable before then. If the option is exercised, §§ 83(a) and 83(b) apply to the transfer of property pursuant to the exercise, and the employee realizes compensation upon the transfer at the time and in the amount determined under §§ 83(a) or 83(b). If the option is disposed of in an arm's length transaction, §§ 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as §§ 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option.

Section 83(h) provides that in the case of a transfer of property to which § 83 applies, there is allowed as a deduction under § 162, to the person for whom the services were performed, an amount equal to the amount included under § 83(a) or § 83(b) in the gross income of the person who performed the services. The deduction is generally allowed for the taxable year of the service recipient that ends in or with the taxable year in which the amount is included in the gross income of the service provider.

Treas. Reg. § 1.83-6(a)(4) denies a deduction under § 83(h) to the extent that the transfer of property constitutes a capital expenditure. The regulation provides instead for an increase in the basis of the property to which the capital expenditure relates at the same time and to the same extent as any amount includible in the employee's gross income in respect of the transfer of the property.

Section 162(a) provides that the deduction that is allowable for ordinary and necessary business expenses paid as incurred in carrying on a trade or business includes a reasonable allowance for salaries or other compensation for personal services actually rendered.

Section 404(a)(5) provides that if compensation is paid or accrued under a plan deferring receipt by the employee, the employer is generally not allowed to deduct the compensation until the year that it is includible in the income of the employee.

Temporary Treas. Reg. § 1.404(b)-1T, A-2(a) provides that for purposes of section 404(a), (b), and (d), a plan, method or arrangement defers the receipt of compensation or benefits to the extent it is one under which an employee receives compensation or benefits more than a brief period of time after the end of the employer's taxable year in which the services creating the right to such compensation or benefits are performed.

Temporary Treas. Reg. § 1.404(b)-1T, A-2(b) states that a plan, or method or arrangement, shall be presumed to be one deferring the receipt of compensation for more than a brief period of time after the end of an employer's taxable year to the extent that compensation is received after the 15th day of the 3rd calendar month after the end of the employer's taxable year in which the related services are rendered ("the 2 ½ month period"). Thus, for example, salary under an employment contract or a bonus under a year-end bonus declaration is presumed to be paid under a plan, or method or arrangement, deferring the receipt of compensation, to the extent that the salary or bonus is received beyond the applicable 2 ½ month period.

Section 421 applies to transfers of shares of stock that meet the requirements of § 422(a). Section 422(a) provides that the rules of § 421 apply to the transfer of a share of stock to an individual pursuant to the exercise of an incentive stock option if certain requirements are satisfied. Section 422(b) provides several requirements for an option to be an incentive stock option. One of those requirements is that the option by its terms is not transferable by the grantee otherwise than by will or the laws of descent and distribution and is exercisable during the grantee's lifetime only by the grantee.

In Revenue Ruling 73-146, 1973-1 C.B. 61, a target corporation paid for the cancellation of outstanding stock options held by some of the target's employees. The cancellation of the outstanding stock options occurred before another corporation purchased all the outstanding stock of the target from the target's shareholders. The Service considered whether the amount paid to cancel the options was a deductible expense arising out of pre-existing compensation obligations or whether it was an expense that had to be capitalized as a cost of the stock purchase. The Service held that the amount paid to cancel the options was deductible as a pre-existing obligation of a compensatory nature.

ANALYSIS

1. Stock Options - Deduction versus Capitalization

Section 422(b)(5) provides that a qualified stock option by its terms must not be transferable by the optionee otherwise than by will or by the laws of descent and distribution. Since the options in this case were in effect transferred by the optionees prior to exercise, otherwise than by the laws of descent and distribution, the rules of § 421, which operate only upon the exercise of a incentive stock option, were inapplicable to the transfer of the options back to [redacted] on [redacted], pursuant to the terms of the merger of [redacted] and [redacted]. Upon transfer, therefore, the options ceased to be incentive stock options, and § 421 did not apply with respect to them; rather, §§ 83(a) and 83(b) applied to the transfer of money when they were disposed of. Consequently, the [redacted] employees were required to include in gross income in [redacted] the excess of the amount received upon the transfer of the options over the amount, if any, paid for them. You have indicated that [redacted] reported the correct amounts of income in the employees' [redacted] Forms W-2.

The nonstatutory stock options granted to employees and directors were not subject to § 83 at the time of grant, as they did not have a readily ascertainable fair market value at that time, and so §§ 83(a) and 83(b) applied to the transfer of money when they were disposed of on [redacted]. Consequently, the affected [redacted] employees and directors were required to include in gross income in [redacted] the excess of the amount received upon the transfer of the options over the amount, if any, paid for them. You have indicated that [redacted] reported the correct amounts of income in the employees' [redacted] Forms W-2 and in the directors [redacted] Forms 1099.

Under § 83(h) and Treas. Reg. § 1.83-6, the service recipient is entitled to a deduction for the amount includible as compensation in the gross income of the service provider under § 83 but only to the extent the amount satisfies the requirements of §§ 162 or 212 and the regulations thereunder. A deduction to the service recipient is denied to the extent that the transfer of property constitutes a capital expenditure. See Treas. Reg. § 1.83-6(a)(4). Under Revenue Ruling 73-146, amounts paid to satisfy compensation obligations of a corporation existing before a reorganization are deductible and do not have to be capitalized as an expense of the reorganization.

In this case, [redacted] was the service recipient, and it paid for the purchase of the options. The amounts paid were includible as compensation in the gross income of the directors and employees, as reflected in the W-2s and 1099s issued by [redacted]. Furthermore, the cancellation of the options was the satisfaction by [redacted] of a pre-existing obligation of a compensatory nature. It was not the satisfaction of a new obligation generated by the merger itself which would represent a cost of the merger requiring capitalization. Accordingly, [redacted] is entitled pursuant to § 162(a) to deduct the amounts paid to purchase the options from the optionees, pursuant to Rev. Rul. 73-146.

2. Stock Options - Period of Deduction

We will provide a response to this question in a future advisory memorandum.

3. Bonuses - Deduction versus Capitalization

Unlike the cancellation of the [redacted] stock options, the payment of bonuses pursuant to the Executive Incentive Plan does not involve a transfer of property, and so the deductibility issue is governed not by § 83, but rather by § 162. Under § 162, bonuses paid to employees are deductible by the employer if they are compensation for services actually rendered and, when added to other compensation paid the employee, are reasonable in amount. You have not questioned the reasonableness of the total compensation paid to the [redacted] employees who received bonuses under the Bonus Plan, and we assume therefore that this is not an issue.

[redacted] is not required to capitalize the payment of the bonuses, because these payments constituted the satisfaction by it of a pre-existing obligation of a compensatory nature. It was not the satisfaction of a new obligation generated by the merger which would represent a cost of the merger requiring capitalization. As a result, the bonuses are deductible under § 162.

4. Bonuses - Period of Deduction

Pursuant to Temporary Treas. Reg. § 1.404(b)-1T, A-2(b),an employer is not allowed to deduct in the current tax year the compensation paid or accrued under a plan deferring receipt by the employee for more than two and one-half months beyond the end of the employer's tax year, regardless of when the services are actually rendered. This deduction-timing rule applies to any method of compensation that has the effect of a deferred compensation plan. Rather, the employer must deduct such compensation in the year that it is includible in the employee's gross income.

Accordingly, the [redacted] bonuses are not deductible on the final short period return for [redacted], notwithstanding the fact that the executives had rendered the services giving rise to the bonuses prior to [redacted], because they were not paid until more than two and one-half months after the end of that taxable period. Therefore, the deduction must be taken in the year the related compensation is includible in the employee's gross income. Because the bonuses were actually paid in [redacted], the recipients will recognize the income for the calendar year ended [redacted]. As such, the deduction for the bonuses properly belongs on [redacted]'s consolidated return for FYE [redacted].

This concludes our advice and recommendation. Please feel free to call Attorney John R. Gilbert at 215-597-3442 with any additional questions you may have. We are forwarding a copy of this memorandum to Division Counsel (LMSB) for mandatory 10 day post review. To assure that National Office has sufficient time to review our advice, we request that you refrain from taking any final action in this matter prior to February 2, 2001.

JAMES C. FEE, JR.
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cc: (via email only)
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